Ontario Economic Council
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NOT FOR RELEASE BEFORE: January 19, 1983

TORONTO, January 19, 1983 The Ontario Economic Council today released a detailed study of the issue of providing inflation protection for private pension plans.

The discussion paper by professor James E. Pesando of the University of Toronto is titled - THE USE OF 'EXCESS' PENSION FUND EARNINGS TO PROVIDE INFLATION PROTECTION FOR PRIVATE PENSIONS.*

Its purpose is to clarify the unanswered questions regarding the implementation and the likely success of an excess earnings approach to inflation protection.

Pesando points out that there are three key issues in the design of an excess earnings scheme: (1) the base rate to be subtracted from the return on the fund (or benchmark portfolio) to measure excess earnings; (2) possible floors or ceilings on the cost-of-living adjustments financed through excess earnings; and (3) the assets to be held in the pension fund reserve for retired plan members (or in the benchmark portfolio).

These features interact to determine the cost, likely degree of inflation protection, and investment incentives created by the excess earnings scheme.

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* This report reflects the view of the author and not necessarily those of the Ontario Economic Council or the Government of Ontario. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of the authors. The decision to sponsor publication of this study was based on its competence and relevance to public policy.

The Pesando study explains that these issues have received too little attention.

Inflation has increased over the past decade or so, and has two important effects.

First, the nominal or fixed-dollar pensions promised by most defined benefit plans are - if not updated by firms - likely to be seriously eroded in real terms.

Second, as interest rates in the marketplace have risen in response to inflationary pressures, the nominal returns on pension funds have increased. In many instances, the returns on pension funds have exceeded the valuation rates used by firms to establish required contributions to their plans. Firms have often used these surplus pension earnings either to reduce their contributions or to improve their pension benefit formulas.

The private pension system in Canada has been the subject of extensive review during the past few years. All the studies published so far have identified the lack of contractual inflation protection in private pension plans as perhaps their most serious limitation.

In backgrounding the issue, Pesando points out that most large firms in Canada have made substantial adjustments to the pensions paid to their retired plan members. Nonetheless, the emerging consensus is that a formal means of providing inflation protection for private pension plans is necessary if these plans are to play an important role in Canada's retirement income system.

Pesando's analysis of the issue supports the following policy recommendations.

1) If inflation protection, properly defined as the removal of uncertainty regarding the real value of pension payments, is given high priority, then the pension fund reserve established for retired plan members (or the benchmark portfolio)

must consist of very short-term bonds, variable rate mortgages or Treasury bills.

2) For a given pension benefit formula, the cost of introducing an excess earnings scheme is potentially quite large, especially if the plan sponsor had not previously been granting 'ad hoc' cost-of-living adjustments. To prevent windfall gains for employees with past service credits at the expense of shareholders, it is appropriate to mandate excess earnings <u>only</u> for <u>future service</u>. Firms could be encouraged to provide some inflation protection for prior service credits, perhaps by excess earnings above a higher base rate.

3) If the pension fund reserve (or benchmark portfolio) held other short-term securities as well as Treasury bills, its expected real return is likely to average 1½ to 2 per cent over the long run. A suitable compromise between risk and return on the pension fund, and between cost and the preservation (on average) of real pension benefits, would be to set the base rate in the excess earnings scheme at 3½ per cent and require or encourage that the pension fund reserves established for retired plan members hold this type of portfolio. Real pension benefits would decline on average at an annual rate of 1½ to 2 per cent, and would <u>not</u> be subject to sharp year-to-year fluctuations.

4) If recommendation #3 is adopted, then the design of the excess earnings scheme with respect to floors and/or ceilings is a less contentious issue. This design problem is treated at length in the discussion paper. If recommendation #3 is accepted, then it would be appropriate to legislate <u>neither</u> a floor nor a ceiling to the excess earnings scheme.

<u>FOR FURTHER INFORMATION CONTACT</u>:

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James Pesando graduated with a Ph.D. from the University of Toronto and is now a professor of economics with the Department of Economics at the University of Toronto and a member of the Pension Research Council, The Wharton School, University of Pennsylvania.

The Use of 'Excess' Pension Fund Earnings to Provide Inflation Protection for Private Pensions, Ontario Economic Council Discussion Paper, 37 pages, price $2.50, is available at the following outlets:

The Ontario Government Bookstore, 880 Bay Street, Toronto, to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in northwestern Ontario, 0-Zenith 67200). A cheque or money order, payable to the Treasurer of Ontario, must accompany all mail orders.

Renouf Publishing Company, Limited, 61 Sparks Street, Ottawa, Ontario K1P 5A6, telephone (613) 238-8985.

The Bookstore, Windsor Public Library, 850 Ouellette Avenue, Windsor, Ontario, N9A 4M9, telephone (519) 255-6765.